

Overview of Consumption Taxes

**Presented to the Revenue and Taxation Interim Committee
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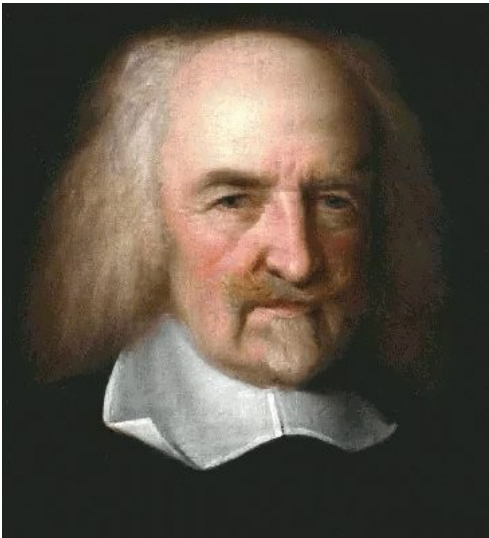


Prepared by the Office of Legislative Research and General Counsel

Why a tax on consumption?

- **Simplicity**
 - Measuring income is complex
 - Capital gains
 - Depreciation
 - Definition of basis
- **Efficiency**
 - No tax on savings
 - Reducing effective tax on capital encourages investment
- **Fairness**
 - Burden imposed on taxpayers to define income
 - Consumption should be the basis of taxation since it is the material basis for the enjoyment of life (Thomas Hobbes, 1651)

Thomas Hobbes on consumption taxes:



“For what reason is there, that he which laboureth much, and sparing the fruits of his labour, consumeth little, should be more charged than he that living idley getteth little, and spendeth all that he gets; seeing that one hath no more protection from the Commonwealth than the other?”

(The Encyclopedia of Taxation and Tax Policy, page 67)

Why *not* a tax on consumption?

- Consumption tax would be highly regressive compared to a tax on income.
- Savings rate relative to income rises with income.
- Extent to which the consumption tax is regressive depends on how it is designed and structured.

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How could a consumption tax be imposed?

- Direct:
 - Retail sales tax or excise tax (broad base that would include all consumption by households, including services)
- Indirect:
 - Income tax with deductions for increases to savings and additions for withdrawals from savings
 - Personal Consumption Tax
 - Report income and net savings
 - Tax liability is based on the difference -- consumption
- Value Added Tax:
 - Value added in production

Is a consumption tax more or less fair than an income tax?

- Consumption tax can appear to be less fair than an income tax:
 - Households with low incomes consume more income than to do higher income households
- On the other hand:
 - Households with temporarily low incomes typically spend at a normal rate while temporary increases in income do not always trigger commensurate increases in consumption;
 - Most households have a typical life cycle of income, savings, and consumption
 - Over a lifetime, some economists argue that consumption tax has more horizontal equity than an income tax

Economic reasons for a consumption tax

- Promotes savings and investment
 - But some economists argue that tax rate has little effect on level of savings
- Removes tax distinctions between:
 - Different types of investment and savings
 - Current and future consumption